CHAPTER II. THE ADMINISTRATION'S ECONOMIC ASSUMPTIONS AND FISCAL POLICY

The economic projections of CBO and the Administration for the next five years are quite similar. In fact, the Administration's short-run forecast for 1983 is slightly less optimistic than that of CBO, in contrast to the case in previous years. Both the Administration and CBO expect economic recovery to begin in 1983 and to be of moderate strength by historical standards. Unemployment falls only gradually in both forecasts, and inflation remains near current levels throughout the five-year projection period. In later years, the Administration's projections of growth in real GNP and inflation are slightly higher than CBO's while unemployment is slightly lower.

Even with the projected recovery, however, the budget outlook is for high and steadily rising federal deficits, assuming no changes in tax or spending policies. The Administration's 1984 budget proposes several measures to reduce these projected deficits by amounts rising from $24 billion in 1984 to $109 billion in 1988, as discussed in Chapter I. If enacted, these measures would change the thrust of federal fiscal policy by significantly reducing projected "structural" deficits. While it is difficult to estimate the short-term economic impact of the proposals, over the longer run they should help to reduce interest rates and promote economic growth.

THE ECONOMIC OUTLOOK UNDER THE ADMINISTRATION'S PROGRAM

The Adminstration's forecast for 1983 shows real growth of 3.1 percent (on a fourth-quarter-to-fourth-quarter basis), while inflation stays near 5 percent, unemployment averages a postwar record annual level of 10.7 percent, and the three-month Treasury bill rate averages 8.0 percent (see Table II-1). By contrast, CBO's forecast shows 4.0 percent growth in real GNP on a fourth-quarter-to-fourth-quarter basis, while inflation, unemployment, and interest rates are all slightly lower than in the Administration forecast. 1/

The Administration estimates for 1984-1988 are not a forecast but rather represent a growth path based on assumptions that are "consistent

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1. For a detailed discussion of CBO's forecast, see Congressional Budget Office, The Outlook for Economic Recovery (February 1983).

TABLE II-1. COMPARISON OF ADMINISTRATION AND CBO ECONOMIC PROJECTIONS (By calendar year)

	1983	1984	1985	1986	1987	1988	1982:4 to 1983:4	1983:4 to 1984:4
				Percent Change (year-to-year)				
Gross National Product (GNP)								
Current dollars								
Administration	6.7	9.3	9.1	8.8	8.7	8.6	8.8	9.2
CBO	6.8	9.6	9.0	8.1	7.6	7.4	8.9	9.6
Constant (1972) dollars								
Administration	1.4	3.9	4.0	4.0	4.0	4.0	3.1	4.0
CBO	2.1	4.7	4.1	3.7	3.5	3.5	4.0	4.7
Prices								
GNP Deflator								
Administration	5.2	5.2	4.9	4.6	4.5	4.4	5.6	5.0
CBO	4.6	4.7	4.7	4.3	3.9	3.8	4.7	4.6
Consumer Price Index								
Administration	4.9	4.6	4.6	4.6	4.5	4.4	--	--
CBO	3.8	4.6	4.7	4.1	3.9	3.7	--	--
				Percent (annual rate)				
Unemployment Rate a/								
Administration	10.7	9.9	8.9	8.1	7.3	6.5	--	--
CBO	10.6	9.8	9.0	8.4	8.0	7.5	--	--
Interest Rate (91-day Treasury bill)								
Administration	8.0	7.9	7.4	6.8	6.5	6.1	--	--
CBO	6.8	7.4	7.2	6.6	6.1	5.9	--	--
"Real" Interest Rate b/								
Administration	2.8	2.7	2.5	2.2	2.0	1.7	--	--
CBO	2.2	2.7	2.5	2.3	2.2	2.1	--	--

a. The unemployment rate predicted by the Administration is for the entire labor force, while that predicted by CBO excludes military workers. Adjusting for this definitional difference involves increasing the Administration's figures by roughly 0.1 percentage point.

b. "Real" interest rates are defined here as the 91-day Treasury bill rate minus the rate of inflation as measured by the GNP deflator.

with the policy objectives of the administration" for reducing unemployment and inflation and sustaining real growth. 2/ These assumptions call for constant 4 percent growth in real GNP, with inflation slowing to the 4½ percent range. Unemployment is projected to decline steadily to about 6½ percent by 1988, close to the Administration's "high employment" benchmark of 6¼ percent. The longer-range CBO projection shows slightly slower growth in the outyears, though the figures are close to the Administration's. The overall similarity in the forecasts is emphasized by the fact that the expected levels of real GNP in 1988 are nearly the same.

ISSUES IN THE ECONOMIC OUTLOOK

Cutting the budget deficit in a period of economic weakness like the present poses dilemmas for policymakers. On the one hand, large deficits persisting after the economy is on the upswing may cause interest rates to rise and crowd out private investment borrowing. This could slow productivity growth and exacerbate inflation in later years. This outlook, together with uncertainty about the course of both monetary and fiscal policy, may be holding up long-term interest rates now, since these rates are sensitive to expected future financial conditions. If this is true, large expected deficits may be slowing the recovery in housing, investment, and other interest-sensitive sectors of the economy.

On the other hand, cutting deficits at a time when the economy is just emerging from recession might delay recovery by reducing current and expected incomes of households and businesses, thereby weakening aggregate demand and GNP.

While reducing the current deficit may not be desirable, enacting large reductions that would be effective in future fiscal years might greatly improve the economic outlook. Such changes would minimize short-term direct reductions in incomes, but might at the same time stimulate current investment and other interest-sensitive spending by reducing long-term interest rates. The Administration's proposals conform broadly to this guideline: no measures materially affect 1983, but later cuts are large enough to reduce the deficit substantially. No one can predict the program's economic impact with confidence--the Administration, for example, provides no indication of what the outlook would be without these measures--but it seems likely to improve the overall outlook, especially in the longer run.

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2. Budget of the United States Government, Fiscal Year 1984, p. 2-8.

The Role of Monetary Policy

The Administration's budget documents say nothing about the assumed behavior of monetary policy. At the time those documents were released, the Federal Reserve had not yet made its annual February announcement of strategies and targets for monetary policy in 1983, and there was unusual uncertainty about the central bank's plans. CBO and others believe, however, that during the next months the Federal Reserve will attempt to ensure, insofar as possible, that a moderate economic recovery occurs. 3/ This might serve to offset, at least in part, any short-term retarding effect of reduced deficits on economic recovery: the Federal Reserve might adjust its targets for short-term money growth so as to improve chances of sustaining the recovery. 4/ The same might be true if the recovery appeared stronger than expected--that is, the Federal Reserve might take steps to slow it down, fearing that an overly rapid expansion would be inflationary.

While it is difficult to estimate the economic impact of the budget proposals, they appear to increase the likelihood that CBO's projection of economic growth and improvements in inflation and unemployment will be realized. Quite apart from this, however, CBO expects that the Federal Reserve may try to steer the economy along roughly the course entailed in the CBO projections, offsetting any significant effects of budget policy. For those reasons, CBO's baseline forecast would not be significantly different if it incorporated the Administration's budget proposals.

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3. For a detailed discussion of the prospective strategy of the Federal Reserve, see Congressional Budget Office, The Outlook for Economic Recovery (February 1983), pp. 78-81.

4. If the central bank expected the impact of a fiscal change to be restrictive, it might not offset it if the bank's own overriding concern was to promote further reductions in inflation rather than steady economic recovery. Even if it is concerned with encouraging recovery, however, the Federal Reserve may fail to offset deficit reductions if it employs expectational economic analysis. In some forms, this analysis implies that budget cuts might have little restrictive impact because they would reduce the public's expectations of future inflation. Reduced inflationary expectations, according to this line of thought, might help maintain economic growth.

TABLE II-2. CBO PROJECTIONS OF STANDARD-EMPLOYMENT DEFICIT WITH AND WITHOUT PASSAGE OF THE ADMINISTRATION'S PROPOSED REDUCTIONS (Unified Budget basis)

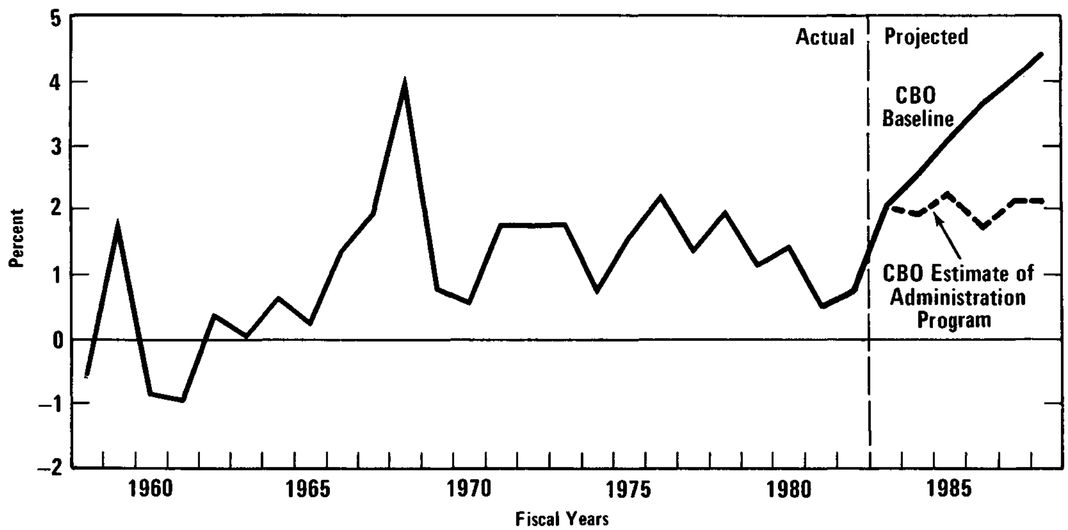
	1983	1984	1985	1986	1987	1988
			Billions of Dollars			
CBO Baseline	72	96	125	155	187	218
With Proposed Reductions	72	71	91	72	97	106
			As a Percent of Standardized GNP			
CBO Baseline	2.0	2.5	3.1	3.6	4.0	4.4
With Proposed Reductions	2.0	1.9	2.2	1.7	2.1	2.1

STRUCTURAL DEFICITS IN THE LONGER RUN

The Administration's proposed reductions in longer-term "structural" deficits should aid economic recovery by reducing interest rates and the tendency for government borrowing to crowd out business borrowing. Table II-2 shows CBO's estimates of one structural deficit measure--the "standard-employment" deficit--both before and after the Administration's proposed reductions. The standard-employment deficit is an estimate of how the deficit would look if the economy were strong enough to keep the unemployment rate at 6 percent. It provides a way of removing the effects of fluctuations in the economy on the budget. Before the Administration's program is taken into account, this deficit measure is projected to reach 4.4 percent of GNP in 1988, a postwar record. Assuming passage of all proposed cuts and implementation of the contingency tax proposals in 1986-1988, this deficit measure falls to 2.1 percent of GNP, which is close to the range of recent experience (see Figure II-1). 5/ Correspondingly, the federal debt

5. GNP has been standardized in these estimates to be consistent with the 6 percent assumed unemployment rate that underlies the "standard-employment" deficit figures.

Figure II-1.
Standard-Employment Deficit as a Percentage of Standardized GNP



SOURCE: Congressional Budget Office.
NOTE: Forecast reflects unified budget deficit standardized at 6 percent unemployment.

held by the public grows significantly more slowly as a percentage of GNP under the Administration's proposals than in CBO's baseline projection (see Figure II-2). Many analysts would argue that reductions of this magnitude would significantly lessen the crowding out of private investment. 6/ For this reason, financial markets may well react favorably and long-term interest rates may fall if the Administration's full program is enacted, and if its proposed contingency tax increases are expected to take effect.

CBO estimates that the contingency tax proposals of themselves would reduce the structural deficit by about one-fifth in 1986-1988. Because they

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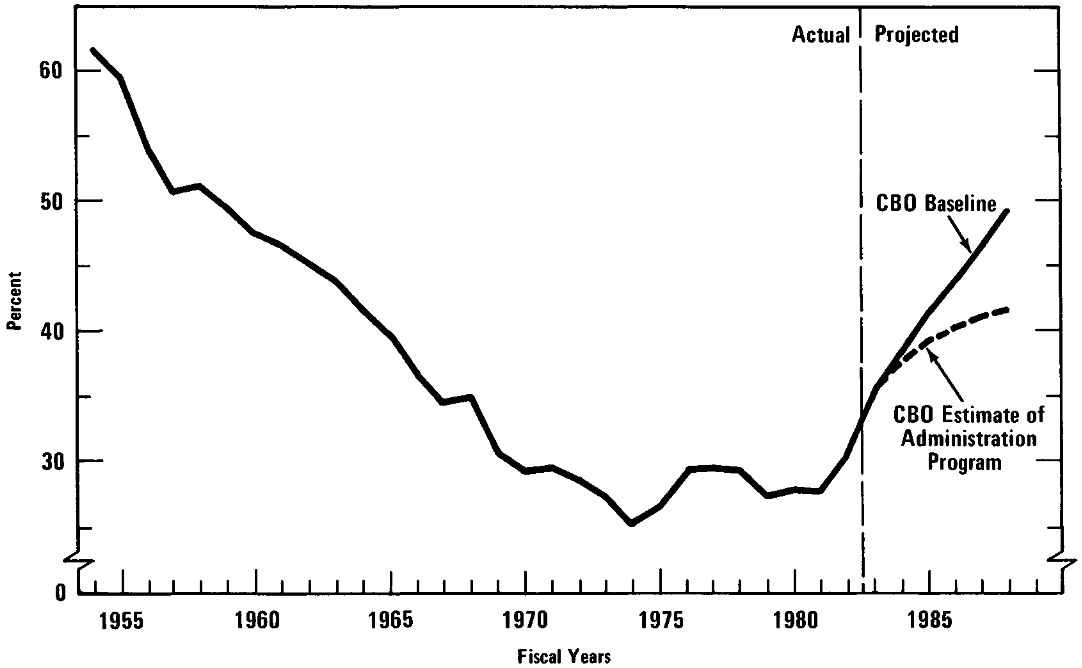
6. For detailed discussion of alternative quantitative criteria to guide reductions in structural deficits, see Congressional Budget Office, The Outlook for Economic Recovery, pp. 61-71.

Figure II-2.
Federal Debt Held by the Public as a Percentage of GNP



SOURCE: Congressional Budget Office.

are contingent on the enactment of other proposals, however, the financial markets may not be convinced that the tax increases will take effect as planned. No one knows what the political outlook will be in 1985, or what unforeseen economic contingencies may have arisen by then, when the taxes are provisionally scheduled to take effect. More concrete and definite measures to reduce expected deficits might be more effective in improving expectations in financial markets.

CHAPTER III. THE ADMINISTRATION'S REVENUE PROPOSALS AND ESTIMATES

The Administration's budget proposes revenues of $659.7 billion for 1984, rising to $1,010.3 billion by 1988 (see Table III-1). The budget includes net increases from proposed new tax legislation of about $11 billion in both 1984 and 1985--attributable mainly to the revenue portions of the proposals of the National Commission on Social Security Reform--followed by much larger increases in 1986-1988, mainly from proposed contingency tax increases. These contingency taxes--a 5 percent surcharge on individual and corporate income tax liabilities and a $5 per barrel tax on imported and domestic oil--would raise $46 billion in 1986 and $51 billion in 1988, according to Administration estimates. In combination with other smaller tax changes proposed by the Administration, these provisions would raise taxes as a percentage of GNP from 18.9 percent in 1984 to 20.6 percent in 1988, close to the post-World War II high of 20.9 percent reached in 1981. Without these proposed tax increases, revenues in 1988 would be 18.9 percent of GNP, according to Administration estimates.

CBO's reestimates of the revenue side of the budget are relatively minor, especially in the near term. CBO estimates that revenues under current law will be $4 billion to $5 billion higher than the Administration estimates in 1984 and 1985, but lower after that--by $7 billion in 1986 and $44 billion in 1988 (see Table III-2). Almost all of these differences arise from differences in economic assumptions: CBO assumes higher rates of real economic growth than the Administration in 1983-1985, and somewhat lower in 1986-1988. Technical estimating differences are small in each year, pushing CBO's estimate above or below the Administration's by $1-$3 billion in 1984-1987, and $8 billion below in 1988.

CBO has reestimated four of the Administration's tax proposals, reducing the estimated revenue gain by $9-$12 billion a year from 1986 to 1988 (see Table III-2). Most of the difference is in the proposed $5 per barrel contingency oil tax. The Administration estimates the revenue gain at $29-$30 billion a year from 1986 to 1988, but this is the amount that would be gained from a $7 per barrel tax. CBO estimates that about $9 billion less a year would be raised by a $5 per barrel tax. CBO also estimates that the proposed 5 percent individual income tax surcharge would raise about $2.2 billion less than the Administration's estimate over the 1986-1988 period. While the budget says that the surcharge is to cover corporate as well as individual taxes, the budget includes only the effects of

TABLE III-1. ADMINISTRATION AND CBO ESTIMATES OF ADMINISTRATION BUDGET REVENUES, BY SOURCE (By fiscal year, in billions of dollars)

	1983	1984	1985	1986	1987	1988
			Administration Estimates			
Individual Income Taxes	285.2	295.6	317.9	358.6	395.7	446.1
Corporate Income Taxes	35.3	51.8	60.5	74.0	84.0	86.7
Social Insurance Taxes and Contributions	210.3	242.9	275.5	304.9	330.3	370.2
Excise Taxes						
Windfall profit taxes	13.8	12.2	11.3	10.5	9.8	9.2
Other a/	23.5	28.1	29.5	64.4	66.5	67.4
Other	29.4	29.1	29.6	29.6	30.0	30.6
Total	597.5	659.7	724.3	841.9	916.3	1,010.3
Percent of Administration GNP	18.7	18.9	19.0	20.3	20.3	20.6
			CBO Estimates			
Individual Income Taxes	285.8	294.8	317.0	358.8	386.3	416.5
Corporate Income Taxes	40.3	55.6	64.9	72.7	81.7	86.3
Social Insurance Taxes and Contributions	212.1	243.3	275.5	302.2	323.7	358.3
Excise Taxes						
Windfall profit taxes	14.4	13.5	12.2	10.3	9.6	9.0
Other a/	23.4	28.4	29.6	52.7	54.1	55.1
Other	30.2	28.9	29.2	28.9	28.4	28.4
Total	606.3	664.5	728.4	825.6	883.8	953.5
Percent of CBO GNP	19.0	19.0	19.1	19.9	19.8	19.9

a. The Administration's budget estimates include the revenue gain from a $7 per barrel fee on oil. The contingency tax actually proposed by the Administration is a $5 per barrel fee. Therefore, the CBO estimates include the estimated revenue gain from a $5 per barrel fee, which is expected to raise about $9 billion less per year than is shown in the Administration's budget.

TABLE III-2. CBO REESTIMATES OF ADMINISTRATION REVENUE PROJECTIONS (By fiscal year, in billions of dollars)

	1983	1984	1985	1986	1987	1988
President's 1984 Budget	597.5	659.7	724.3	841.9	916.3	1,010.3
CBO Reestimates of Existing Law						
Economic assumptions	a/	2.0	3.9	-5.7	-18.8	-36.0
Technical reestimates	8.8	2.7	0.5	-1.4	-3.1	-8.3
Subtotal, existing law	8.8	4.7	4.4	-7.0	-22.0	-44.3
CBO Reestimates of Administration Revenue Proposals						
Economic assumptions	---	a/	-0.6	-0.9	-2.1	-4.2
Technical reestimates	---	a/	0.2	-8.4	-8.5	-8.3
Subtotal, revenue proposals	---	0.1	-0.4	-9.3	-10.6	-12.4
Total Reestimates	8.8	4.8	4.1	-16.3	-32.6	-56.7
President's 1984 Budget as Estimated by CBO	606.3	664.5	728.4	825.6	883.8	953.5

a. Less than $50 million.

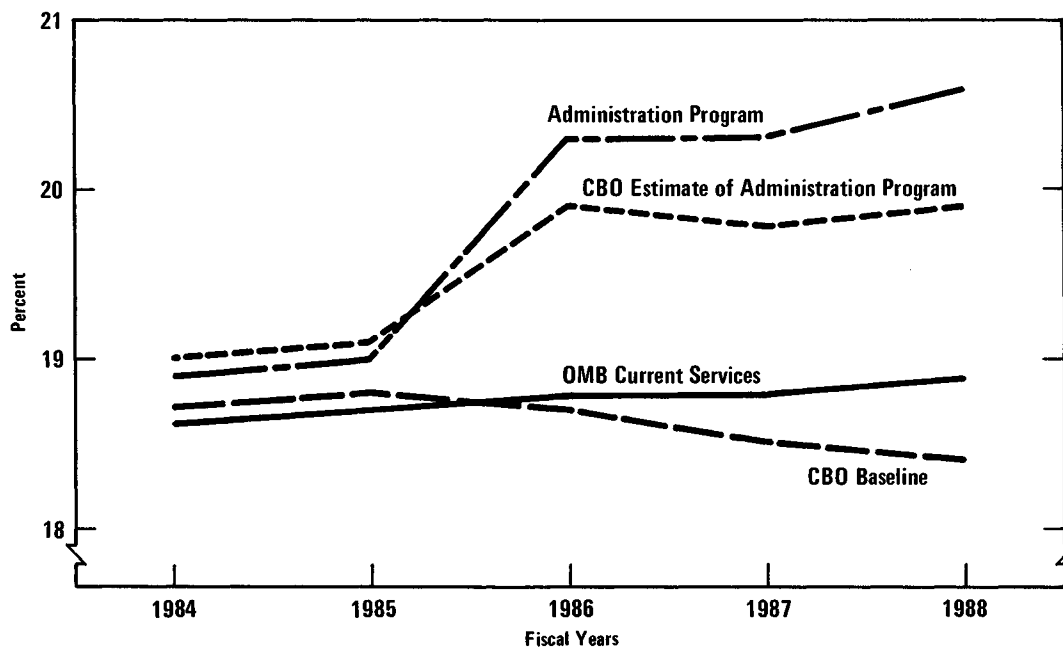
an individual surcharge. Finally, CBO's estimate of the revenue gain from the Social Security Commission proposals is somewhat below the Administration estimate, while CBO's estimate of the revenue gain from higher Civil Service Retirement contributions is somewhat above the Administration's.

In addition to the contingency, Social Security, and Civil Service Retirement tax increases, the Administration has proposed a number of smaller tax changes aimed primarily at achieving nontax goals. These include a cap on the amount of employer-paid health insurance that can be excluded from taxation; tuition tax credits and tax-exempt savings accounts for education expenses; a jobs tax credit for the long-term unemployed; a variety of special tax incentives for investment in enterprise zones; and proposals to help Caribbean Basin countries. Taken together, these proposals would raise a net total of $1.8 billion in 1984 and $8.4 billion in 1988.

The first part of this chapter analyzes the revenue proposals in the Administration's budget and some possible alternatives; the second compares the CBO estimates of receipts under existing tax law to those of the Administration. In broad terms, as shown in Figure III-1, the Administration

Figure III-1.

Federal Revenues as a Percentage of GNP Under the Administration Program and Current Policies



SOURCES: *Budget of the United States Government, Fiscal Year 1984;* and Congressional Budget Office.

NOTE: The revenues for the Administration program and for OMB current services are shown as a percentage of GNP as forecast by the Administration, whereas the revenues for the CBO estimate of the Administration program and for the CBO baseline are shown as a percentage of GNP as forecast by CBO.

and CBO estimates both of revenues under current law (current services or baseline revenues) and of the effects of the Administration's program as a whole, are very similar in 1984 and 1985. Beginning in 1986, however, CBO's estimate of baseline revenues drops below the Administration's current services estimate, reflecting mainly CBO's lower growth rate assumptions. CBO's estimate of the revenue gain from the new proposals in the Administration program is also lower in 1986-1988, reflecting mainly CBO's estimate of lower collections from the $5 per barrel oil tax.

THE PRESIDENT'S REVENUE PROPOSALS

The 1984 budget was written against a backdrop of very large federal deficits for the entire forecast and projections period. The revenue proposals thus seek for the most part to increase receipts. The revenue increases would come mainly from contingency taxes--$46.0 billion in 1986 and $51.4 billion in 1988 (see Table III-3). These taxes would go into effect in 1986 only if the deficit was large and the economy was growing at that time, and if the Congress had passed the Administration's deficit reduction measures. All the Administration's proposals combined would increase federal revenues to 18.9 percent of GNP in 1984, 19.0 percent in 1985, and 20.6 percent in 1988, according to Administration estimates (see Table III-1). Without the contingency taxes, 1988 revenues would be much less--19.6 percent of GNP. These ratios compare to a post-World War II high of 20.9 percent in 1981, and an average of 18.6 percent in the 1960s and 18.9 percent in the 1970s.

If revenue measures are chosen to close part of the budget gap, two factors must be considered. First, because the deficit is projected to be large throughout the budget planning period and beyond, and because tax revenues now grow significantly more slowly as the economy expands (as is demonstrated later in this chapter), the long-term yield of revenue proposals is especially important. Second, it is essential that revenue measures themselves not slow the economy, especially in the early stages of recovery, or blunt economic incentives to work, save, and invest.

The revenue proposals in the budget are analyzed in the following sections.

Contingency Taxes

The budget contains a contingency tax plan that would take effect in fiscal year 1986 only if the Administration forecasted on July 1, 1985, that the deficit for 1986 would exceed 2.5 percent of GNP; if the economy was growing; and if the Congress had passed the Administration's deficit reduction measures. The contingency tax plan consists of two parts: an individual and corporate income tax surtax and an excise tax on petroleum.

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TABLE III-3. ADMINISTRATION AND CBO ESTIMATES OF REVENUE CHANGES FROM ADMINISTRATION PROPOSALS (By fiscal year, in billions of dollars)

Proposal	1984	1985	1986	1987	1988
			Administration Estimates		
Bi-Partisan Social Security Plan	8.2	5.8	8.9	10.7	22.3
Contingency Tax Plan					
Income tax surtax	---	---	17.4	19.0	21.4
Petroleum excise tax	---	---	28.6	30.0	30.0
Taxation of Health Insurance Premiums	2.3	4.4	6.0	8.0	10.7
Higher Education Tax Incentive	a/	-0.1	-0.2	-0.3	-0.4
Tuition Tax Credit	-0.2	-0.5	-0.8	-0.8	-0.8
Jobs Tax Credit	-0.2	-0.2	-0.1	a/	a/
Enterprise Zone Tax Incentives	-0.1	-0.4	-0.8	-1.1	-1.1
Caribbean Basin Initiative	a/	a/	a/	a/	a/
Contributions to Civil Service Retirement	1.2	2.3	2.1	1.9	1.7
Other	a/	a/	a/	a/	a/
Subtotal	11.2	11.3	61.3	67.5	83.9

(Continued)

TABLE III-3. (Continued)

Proposal	1984	1985	1986	1987	1988
Administrative Action b/	-0.3	-0.3	-0.3	-0.3	-0.3
Total	10.9	11.0	61.0	67.3	83.6
Percent of Administration GNP	0.3	0.3	1.5	1.5	1.7
		Addendum: CBO Reestimates			
Bi-Partisan Social Security Plan	8.2	5.2	8.1	9.2	19.7
Contingency Tax Plan					
Income tax surtax	---	---	17.3	18.4	19.9
Petroleum excise tax c/	---	---	19.8	21.0	21.0
Contributions to Civil Service Retirement	1.2	2.5	2.5	2.5	2.4
Net Change from CBO Reestimates	0.1	-0.4	-9.3	-10.6	-12.4
Reestimated Total for All Administration Proposals	10.9	10.6	51.7	56.6	71.1
Percent of CBO GNP	0.3	0.3	1.2	1.3	1.5

SOURCES: Budget of the United States Government, Fiscal Year 1984, and Congressional Budget Office.

a. Less than $50 million.
b. The effect of the proposed October 1983 federal employee pay freeze on federal employee retirement contributions.
c. Joint Committee on Taxation and CBO estimate.

The combined yield of the taxes is intended to be approximately 1 percent of GNP; they would remain in effect for up to three years. (The budget does not say what, if anything, would cause the contingency taxes to last for less than three years.)

The proposal has the advantage of establishing the intent to raise taxes, but postponing the increases to a date when the economy would be stronger. On the other hand, the contingency tax plan depends on forecasts of both the deficit and GNP. Because such forecasts are often unreliable and always controversial, the triggering of the contingency taxes could be the subject of much uncertainty and dispute. But perhaps more important, the temporary contingency taxes might not be the best solution for what appears to be a continuing budget problem. Both the CBO and the Administration estimates indicate that the deficits will be substantial even after several years of economic growth. The Administration projects the 1988 budget deficit, if all of its spending reduction proposals are adopted but not counting the contingency tax revenues, at 3.4 percent of GNP (excluding off-budget spending). Thus in 1989, after the contingency taxes expired, the deficit would still be a serious problem. CBO's analysis later in this chapter shows that faster growth within a reasonable range will not narrow the deficit appreciably from the revenue side. It would seem inadvisable to enact temporary taxes for 1986-1988 when the evidence indicates that the need for additional revenue will not end in the foreseeable future, absent spending reductions substantially greater than those proposed by the Administration.

Any tax increase could be repealed in the future if economic growth closed the budget gap more rapidly than expected. The advantage of putting such a tax increase firmly and immediately on the books is that it would reassure the financial markets that future federal credit demands will not become burdensome. This would reduce, to some degree at least, upward pressure on interest rates.

The Surtax. The first part of the contingency tax plan is a 5 percent surtax on individual and corporate income tax liabilities. It would increase revenues by $17.4 billion in 1986, $19.0 billion in 1987, and $21.4 billion in 1988, according to Administration projections.

There is some uncertainty about the exact nature of the Administration's proposed surcharge. The budget describes it as "a surcharge on individuals and corporations approximately equivalent to 1% of taxable income," while the Treasury Department fact sheet describes it as "a surcharge of 5% on taxes paid by individuals and corporations." The revenue projections in the Administration budget, however, include a 5 percent surcharge on only individual income taxes. CBO estimates that the yield from this individual surcharge will be $0.1 billion less than the Administration estimates in 1986, $0.6 billion less in 1987, and $1.5 billion less in 1988, reflecting the lower projected CBO growth rates and incomes in those years. If a 5 percent surtax on corporate income tax liabilities was added to this, CBO estimates that about $3 billion more would be collected in 1986, and about $4 billion more in both 1987 and 1988. If the corporate surcharge was applied to taxes owed before deduction of investment and foreign tax credits (as was done with the Vietnam War surcharge), the revenue gain could be as much as twice as high.

An individual surtax can be calculated as a percentage of tax liability (as in the budget proposal) or as a percentage of income. The latter would place a relatively lighter burden on taxpayers with the highest incomes. Whatever its design, an individual surtax increases effective marginal tax rates, thus discouraging work, saving, and investment. The Administration's proposed surtax, for example, would increase the top marginal rate on individuals from 50 to 52.5 percent. A corporate surtax would likely have an even greater adverse impact on investment, because corporations usually invest large shares of their after-tax income. (Of course, corporations could adjust by reducing their dividend payments and increasing their borrowing, but this would reduce investment resources elsewhere in the economy.) Unless a corporate surtax accompanied the individual surtax, however, some would argue that the additional tax burden bore too heavily on households.

If the Congress decided to replace the contingency tax plan with unconditional and permanent tax increases, there could be several alternatives to the surtax. Some tax increase options and their estimated additions to revenues are shown in Table III-4. A simple tax rate increase might be more attractive than a permanent surtax, because the surtax would add a stage to the tax computation process while the rate increase would not. One option would be repeal of the 1983 10 percent rate cut. This would raise $30 billion in 1984 and $40 billion in 1988, compared to about $20 billion in 1988 for the proposed 5 percent surtax. Alternatively, the 1983 tax cut could be reduced to 5 percent, yielding half of the additional revenue of outright repeal. Another alternative would be to defer the tax cut in whole or in part until a later year.

Another option would be to cap the 1983 tax cut at $700 per joint return; this would have the effect of limiting the implicit tax increase to couples with incomes greater than about $50,000, and somewhat less for single persons. The cap option would raise far less revenue than repeal, however--$6 billion in 1984 and $9 billion in 1988. Repealing or reducing the 1983 tax cut would have the disadvantage of increasing tax revenues in the near term, when the economic recovery might still be fragile.

TABLE III-4. ESTIMATED REVENUE GAINS FROM MAJOR TAX INCREASE OPTIONS (By fiscal year, in billions of dollars)

Option	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Repeal July 1, 1983 Rate Reduction	30	33	35	38	40	177
Cap Third-Year Tax Rate Cut at $700	6	7	7	8	9	37
Repeal Indexing	--	6	17	28	40	90
Some Possible Base-Broadening Options						
Tax some employer-paid health insurance	3	5	6	7	9	30
Eliminate deductibility of state and local sales taxes	1	6	6	7	8	28
Limit nonbusiness, non-investment interest deductions to $10,000	1	2	2	2	2	9
Tax the accrued interest on life insurance reserves	2	6	7	8	9	31
Repeal net interest exclusion	---	1	3	3	4	11
Eliminate income averaging	3	4	4	5	5	21
Lengthen building depreciation period to 20 years	a/	2	4	6	8	19
Require full basis adjustment for the investment tax credit	a/	1	2	4	5	12

SOURCE: Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options (February 1983), Chapter X and Appendix A. Assumes January 1, 1984, effective dates. Numbers may not add to totals because of rounding.

a. Less than $0.5 billion.

Yet another option would be to repeal the provision for indexing income taxes in 1985 and later years. Indexing would have the advantage of preventing unlegislated, automatic tax increases brought about by inflation, but it would widen the deficit correspondingly. The recent slowdown of inflation may make the need for indexing seem less urgent than was originally thought. The revenue gain from repealing indexing would be greatest if the economy grew rapidly, and least if the economy was sluggish; thus it would act as a brake on an overheated economy while not retarding a sluggish one. Repeal of indexing would not increase taxes until 1985, and thus would not impair the current recovery; it would raise $6 billion in 1985 and $40 billion in 1988. Alternatively, indexing could be postponed one or several years, rather than repealed outright.

Several income tax base-broadening steps might be substituted for a general surtax. These are also listed in Table III-4, and discussed in detail in CBO's Reducing the Deficit: Spending and Revenue Options (February 1983). Such base broadening would have the disadvantage of concentrating the tax increase on certain specific groups, but might also make the tax system more equitable and neutral with regard to different economic activities. One option, taxing part of employer-paid medical insurance premiums, is included in the Administration's budget proposal and is described later in this chapter. Other options, taken from the larger list in Reducing the Deficit, include limiting the deductibility of nonbusiness, noninvestment interest; taxing the accrued interest on life insurance reserves; repealing the net interest exclusion; eliminating income averaging; eliminating the deductibility of state and local sales taxes; lengthening the building depreciation period to 20 years; and requiring a full basis adjustment for the investment tax credit. Combining several of these base-broadening steps could raise as much revenue as the proposed surtax.

The Petroleum Excise Tax. The Administration's budget proposal includes a temporary contingency tax on consumption of imported and domestic oil. Although the budget specifies a $5 per barrel tax, the revenue estimates in the budget are based on a $7 tax, not a $5 tax. A $5 tax would raise approximately $9 billion less per year than estimated in the budget, or $27 billion less over the life of the tax (see Table III-3). (This revenue shortfall could, of course, be made up in some other way within the contingency tax program.) If the $5 tax took effect on October 1, 1985, it would raise an estimated $62 billion in revenue over the 1986-1988 period. 1/ To the extent that consumer prices were increased by the tax,

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1. Gross collections would be $83 billion before offsetting reductions in receipts from individual and corporate income and gasoline excise taxes. Possible offsets from higher outlays are not included.

part of the revenue would be offset by increased outlays in programs sensitive to changes in consumer prices, such as Social Security.

An oil tax would have certain effects that might be desirable from an energy policy standpoint. To the extent that it was shifted onto consumers, the tax would reduce the demand for oil, and therefore U.S. dependence on imported oil. In addition, it would increase incentives for the development of alternative energy sources (such as coal, natural gas, or solar energy), as well as raise the payback from conservation efforts by consumers. To the extent that it reduced petroleum imports, it would also limit the economic costs of any future supply disruption. In this context, a permanent tax would be more effective, because consumers would be more likely to change their behavior if they knew the tax was not temporary.

An oil tax would distort the relative prices of different fuels for consumers and could produce some economic inefficiencies. For example, it might lead New Englanders to switch from fuel oil to natural gas or coal for home heating, even though the economic costs of these fuels in that area are higher than for oil. This suggests that an ad valorem (percentage-of-price) tax on all energy consumption might be preferable to a tax solely on oil. For example, a 5 percent tax on all energy consumption would raise about the same amount (about $60 billion over 1986-1988) as a $5 per barrel oil tax, but it would not distort relative fuel prices. (The $5 per barrel tax is equivalent to a 17 percent ad valorem tax, assuming a $30 per barrel price.) In addition, a broad-based tax would tend to even out the regional variations in tax burdens that would result from a tax limited to oil.

The inefficiencies and distortions of a tax limited to oil may be a price worth paying for greater energy independence, however. In addition, a broad-based energy tax would not be without economic distortions. While it would be neutral among fuels, it would still distort the choice between energy-intensive goods and other goods. An ad valorem tax may also be more difficult to administer, since the "value" of a product grows at each stage of production and distribution, and may be difficult to determine precisely at some stages.

The current state of the oil market makes it attractive to impose an oil tax now rather than waiting until 1985 because declining oil prices would offset part (or all) of the tax. A $5 per barrel tax in the near term would thereby prevent the price of oil from falling as much as it would otherwise, preserving part of the energy conservation price incentives that currently exist. If part of the tax was absorbed by producers, the price of oil products would not rise by the full amount of the tax. So long as the market remained soft, the federal government would divert to itself part of the gain from high oil prices currently received by foreign as well as domestic